



Napa Wealth Management's The Sensible Investor



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Inflation – The Other Side of the Coin

By George P. McCuen, CFP®, President



Are we currently in an inflationary or deflationary economy? This question is being pondered by many economists with compelling arguments on both sides. Let's plumb the depths of the inflation argument to get an idea of why this isn't so black and white.

I will begin with some definitions. According to Webster's Dictionary published in 1983, inflation is defined as, "An increase in the amount of currency in circulation, resulting in a relatively sharp and sudden fall in its value and rise in prices: it may be caused by an increase in the volume of paper money issued or of gold mined, or a relative increase in expenditures as when the supply of goods fails to meet the demand". Here Webster defines inflation not simply as an increase in prices but as the increase of supply of money that causes the increase in prices.

In 2000 Webster defines inflation as "A persistent increase in the level of consumer prices or a persistent decline in the purchasing power of money, caused by an increase in available currency and credit beyond proportion of available goods and services". A closer look would highlight the cause of inflation as either an increase in money supply or a decrease in available goods and services. Interesting isn't it?

Here is a brief history lesson to give us a background on inflation's roots. Back in the days of FDR we were on the gold standard. In those days the dollar was backed by gold so they couldn't simply print more money since there had to be gold in the treasury. Since 1880 the U.S. dollar official gold price had been \$20.67 per ounce.

In 1913 the Federal Reserve was created and that is when inflation began. From 1913 through 1920 inflation (as measured by the Consumer Price Index – CPI) had almost doubled but the price of gold remained flat, by government decree.

But because the official gold price the government had on its books was much lower, the backing was out of sync with the inflated dollars.

FDR mandated that citizens turn in their gold at the then fixed price (\$20.67/oz) and then the government promptly raised the price of gold to the "real" market price of \$35 an ounce. That maneuver created instant money at the expense of the American people. This action could not be repeated for two reasons; gold was no longer undervalued and people didn't have any more gold to steal, I mean purchase.

We have not been on the gold standard since Richard Nixon's presidency. Now the government can print money to their heart's delight. Unfortunately this comes with a price. Going back to the definitions, as the total supply of dollars grows, each individual dollar becomes worth less and less.

From August 1979 until August 2009, prices have increased 192%. \$1 in 1979 would have to be \$2.92 in 2009 in order to hold its purchasing power. Inflation is the thief of wealth - it secretly steals your savings.

Another inflationary indicator is the price of precious metals. If inflation takes root then the price of commodities will increase. Gold has been on an upward run and is at a multi-decade high, another telling indicator. I can't ignore the devaluation of the dollar as a reason investors have been turning to gold, but I would be remiss if I didn't highlight the price movement of precious metals in a discussion about inflation.

Is inflation already here? Most people think of inflation as just being rising prices. Rising prices are a symptom of inflation. The other ingredient of inflation is increasing supply of new money outpacing the production of goods and services. This sounds like the environment we are in right now doesn't it? The government has had the U.S. Dollar printing presses on

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To Roth or not to Roth?

By Jim Riley, CFP®, EA, Senior Financial Advisor

Whether or not to convert a traditional IRA to a Roth IRA has been a topic of much discussion in the financial world of late. What's all the fuss?

The basic difference between a traditional and a Roth IRA is that distributions from a Roth IRA are not taxable (depending on the circumstances) and that distributions from a traditional IRA are taxable (depending on the circumstances).

In 2009 and in years previous you were allowed to convert from a traditional to a Roth subject to income limitations. In 2009, for example, a married couple could not effect a conversion if their income was over \$176,000 – a single individual would be allowed to convert if their income was under \$120,000.

The 'fuss' is that in 2010 the income limitation is permanently repealed. Furthermore, if you convert funds from a traditional IRA to a Roth in 2010 you may either include the income on your 2009 tax return OR split the income equally between 2011 and 2012.

Should you convert? Mutual fund companies and some members of the financial press maintain if you anticipate that your tax rates will be greater when it's time to tap the Roth then it's probably a good plan. Probably.

The truth is this: Traditional IRA's, Roth conversions, Roth distributions, Roth rules in general are very complex. The liberalization of the Roth limits is a significant development and potentially an excellent planning tool. However, whether or not to convert is absolutely, positively an individual decision that needs careful research and consideration. The simple internet based Roth conversion "calculators" do not provide a comprehensive answer - at least for most individuals.

I strongly urge anyone considering a Roth conversion to contact us before you act. We have on our staff yours truly. I am licensed to practice taxation, I have prepared thousands of tax returns, and I have the tools to help you and yours to come to a decision.

Frankly speaking,

Jim

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high speed for over a year!

What are the repercussions of inflation on bonds? Bonds would see their prices decrease if we see rates increase. This could result in a Treasury bubble burst if rates increase dramatically. The bond market is signaling that rising rates are ahead. In March 2009 the 10-year Treasury was yielding 2.8% and we projected that rates would increase to 4.5% in 2010. Recently the 10-year Treasury's yield has been hovering around 3.2% so the trend is gradually moving higher.

Stocks from companies with strong fundamentals and solid earnings to support their dividends can do well in an inflationary environment. These companies raise their

prices to keep up with inflation. Investors also can enjoy getting paid consistent income through dividends.

So you are now armed with enough information to answer our opening question, inflation or deflation? Take out your coin and flip it.

Keep looking up!

George

Comprehensive Tax Services

Schedule an appointment with Jim Riley today!
Jim, an Enrolled Agent, is accepting new tax preparation clients.